Australian Government
Department of Employment

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Proposal paper: Improving bankruptcy and insolvency laws

Thank you for the opportunity to comment on the *Improving bankruptcy and insolvency laws* proposal paper released on 29 April 2016.

The Department of Employment has a keen interest in these proposals. While the Department broadly supports the reforms, there is potential for unintended and inappropriate consequences in terms of demand and cost under the Fair Entitlements Guarantee (FEG) scheme and the range of actions available to pursue recovery of funds under the FEG Recovery Program that need to be considered and addressed. These issues have been detailed in the Department's submission (attached).

I would appreciate continuing collaboration between our respective agencies as these proposals are further developed. I am concerned to ensure that the intended interaction of the three reforms be examined in depth for their potential to encourage 'sharp corporate practices'. The Department of Employment has commissioned a range of work on the impact on FEG of 'sharp corporate practices' arising from moral hazard in the program. Once completed, this work may provide further useful information for consideration in progressing the proposed reforms.

I note that the recent Productivity Commission Review on Business Set-up, Transfer and Closure included a recommendation, made in the context of these reform proposals, that the FEG be reviewed to monitor any moral hazard issues, any potential abuse of the scheme and the continued effectiveness of recovery arrangements. The Department of Employment supports this recommendation as it will enable a critical post-implementation review mechanism to provide assurance (or otherwise) around any unintended impacts of these reforms.

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Yours sincerely

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Australian Government
Department of Employment

National Innovation and Science Agenda

Department of Employment Response to Proposals Paper *Improving bankruptcy and insolvency laws*

Introduction

The Fair Entitlements Guarantee Scheme

The Department of Employment ('the Department') welcomes the opportunity to provide comment on the Improving bankruptcy and insolvency laws proposals paper ('the Proposals Paper'). The paper proposes three significant reforms to Australia's insolvency laws, adopting the recommendations of the Productivity Commission in its report, 'Business Set-Up, Transfer and Closure' ('the Productivity Commission report').[1]

The purpose of this submission is to consider the potential impact of the proposed reforms on the Department's administration of the *Fair Entitlements Guarantee Act 2012* (Cth) ('the FEG Act').

The Department administers the Fair Entitlements Guarantee (FEG) scheme, which is a legislative safety net of last resort that provides financial assistance for certain unpaid employment entitlements owing to eligible employees who lose their jobs due to the liquidation or bankruptcy of their employer. Once a FEG advance is made, the Department steps into the shoes of the employee as a subrogated creditor with standing to recover FEG funds in the winding up or bankruptcy.

FEG is a demand driven scheme, it doesn't operate against a specific quota or target. It simply responds to whatever demand presents as shifts occur in economic conditions and insolvency rates across Australia. There has been a significant growth in demand since the Global Financial Crisis, with assistance increasing from 7,808 workers (across 972 insolvent entities) paid $60.8 million in 2007–08 to 19,074 workers (across 2060 entities) paid $312.5 million in 2014–15. Entitlements that can be paid under FEG include unpaid wages, annual leave and long service leave, as well as payment in lieu of notice and redundancy pay (some payment thresholds apply).

The stated aim of the reforms is to improve bankruptcy and insolvency laws through striking a better balance between encouraging entrepreneurship and protecting creditors. Any reform which has potential to alter the existing status quo on the number of companies that are wound up with insufficient funds to meet employee entitlement obligations would most likely lead to a cost impact on FEG. If the proposed reforms are successful in providing an opportunity for companies, which would otherwise have wound up, to trade out of their difficulty, there will likely be a positive impact on the cost of the publically funded FEG safety net. However, where the proposed reforms do not unilaterally result in decreased company windups, the FEG scheme faces greater financial exposure due to the risk that assets of distressed companies are eroded while

[1] Productivity Commission, *Business Set-Up, Transfer and Closure* (30 September 2015) http://www.pc.gov.au/inquiries/completed/business/report/business.pdf.

higher employee entitlement liabilities are incurred through trade-ons in support of unsuccessful business restructures.

The risk to FEG is exacerbated where company restructures are facilitated through sharp corporate practice. Bruck Textile Technologies (BTT) provides an example of the tension that business restructuring poses for FEG.

BTT was a high profile case that attracted significant media and political interest due to reliance on FEG to pay entitlements while the business itself was restructured under a related entity owned by the same directors. Key details include:

- BTT was registered in 1996. BTT was a privately owned company that had been manufacturing a large range of performance and protective fabrics since 1946 (for example, military, mining, fire-fighting).
- On 10 July 2014, the business and assets of BTT were sold for $1 plus the assumption of certain liabilities totalling $11.247 million to Australian Textile Mills (ATM). ATM was a related entity of BTT under the parent company, Australian Textile Group.
- The majority of BTT assets were transferred to ATM as part of the sale, including plant and equipment, inventory, intellectual property and contractual assets.
- Not all BTT employees were transferred to ATM. 120 employees were transferred with ATM taking on liability for accrued employee entitlements. 58 employees were retrenched by BTT, with liability for employee entitlements remaining with an assetless BTT entity following the sale to ATM.
- FEG paid $3.485 million in unpaid employee entitlements to the 58 retrenched employees.

It is the Department's experience that of the 1,500 or so corporate insolvencies each year where FEG assistance is required to meet employee entitlements, full recovery of that publicly funded assistance rarely occurs.

On 1 July 2015 the Fair Entitlements Guarantee (FEG) Recovery Programme was established. Under the FEG Recovery Programme, the Department funds liquidators of companies for the purposes of pursuing recovery proceedings and other activities to increase assets available to creditors in the winding up, including FEG as a subrogated creditor. The programme is proving highly successful in improving FEG recovery rates, yielding close to $18 million in increased dividend recovery within the first year. In addition, the programme is highlighting key areas of insolvency law which require close attention to minimise the impact of sharp corporate practice and undue reliance on the taxpayer funded FEG scheme.

Key activities that can be launched to improve recoveries in liquidation are potential insolvent trading actions against the former directors or company controllers. Any proposed reform which serves to improve defences of directors from personal liability for insolvent trading has capacity to limit the effectiveness of the FEG Recovery Program, particularly in circumstances where safe harbour protections are used alongside sharp practice to effectively avoid liability for employee entitlement liabilities.

The Department's submission is broadly directed to consideration of the safe harbour proposal on the basis that this poses the highest risk to FEG. Funds otherwise available to meet employee entitlements could be consumed during the period of safe harbour. Coupled with the accrual of additional employee entitlements liability within the company during any period of safe harbour, the proposal exposes the Commonwealth and all other creditors to additional risk. Any reform which provides incentive for unviable entities to continue trading rather than enter administration requires careful consideration of the possible flow on effects to taxpayer funded programs such as FEG.

The Productivity Commission report included the recommendation that a review be undertaken of the FEG scheme to monitor any moral hazard issues, any potential abuse of the scheme and the continued effectiveness of recovery arrangements. The Department considers that such a review is essential in designing these reform proposals as a mechanism to provide assurance (or otherwise) on any unintended impacts of the reforms.

Safe Harbour Model A

Query 2.2

Subject to the further information on the proposal set out in the sections below, the Government seeks views from the public on whether this proposal provides an appropriate safe harbour for directors.

The Department is of the view that of the two proposals set out in the paper, Model A provides the most appropriate safe harbour for directors. Although Model A may be more complex and require company directors to incur costs, the appointment of a suitably qualified restructuring adviser would provide the best balance between providing an opportunity for a company to recover from financial distress whilst protecting the interests of the company's creditors including employees and the Commonwealth where FEG pays employee entitlements.

The Department notes that under Model B, it would also be open to directors to seek the formal appointment of an adviser to provide advice on restructuring issues as part of their requirement to take 'reasonable steps' to maintain or return the company to solvency within a reasonable period of time. The Department is concerned that the appointment of advisers outside of a process regulated by statute (in contrast to Model A) may be more likely to lead to unscrupulous behaviour and the potential exploitation of the safe harbour model.

Notwithstanding the above, the Department believes that further refinement around the operation of Model A is needed to ensure the interests of creditors, including the Commonwealth, are protected.

In particular, the Department suggests that consideration be given to the introduction of a 'Restructuring Plan', a key document which sets out the basis for the restructuring adviser's view as to the viability of the business and opinion that it can be returned to solvency, and the steps that will need to be taken for this to occur.

We envisage that the Restructuring Plan would be in a prescribed form and include details of:

- any employee entitlements owing or outstanding at the time safe harbour was entered;
- the quantum of employee entitlements that would crystallise if the company was wound up;
- how employee entitlements would be met during the safe harbour period associated with any restructuring of the company; and

- the probability of the company being able to pay the employee entitlements after the safe harbour and any restructuring is implemented.

Other important matters, such as the nature and cost of restructuring actions, could also be prescribed in the Restructuring Plan for the benefit of all creditors and could serve as a key forensic document in circumstances where the business has failed, despite a safe harbour opportunity.

Query 2.2.1a

The Government seeks views from the public on what qualifications and experience directors should take into account when appointing a restructuring adviser and whether those factors should be set out in regulatory guidance by the Australian Securities and Investments Commission, or in the regulations.

The appointment of an adviser should be considered on a case-by-case basis, having due regard to appropriate matters such as the size of the company, the nature of the liquidity issue(s), the expertise of the restructuring adviser and an estimate of their professional fees and expenses. It is unclear on the face of the current proposal what consequences ensue for the failure of a director to appoint an appropriately experienced and qualified restructuring adviser. For example:

- Should the failure result in the safe harbour defence being unavailable?
- Should a civil penalty be imposed on the director?
- Will the failure result in a breach of the statutory and/or common law duties to act in good faith and the best interests of the company?

The appropriateness of statutory or non-statutory guidance material will flow, in large part, from further consideration of the above questions.

Query 2.2.1b

The Government seeks views from the public on which organisations, if any, should be approved to provide accreditation to restructuring advisers if such approval is incorporated in the measure.

The Department is of the view that only professionals with significant experience in insolvency, restructuring, turnaround or corporate renewal and associated professional behaviour standards should have accreditation authority.

The restructuring adviser holds a position of trust and confidence and any accreditation process for restructuring advisers should include at a minimum that the adviser:

- is a 'fit and proper' person;

- complies with ongoing conditions of appointment directly relating to maintaining independence and the avoidance of any conflicts of interest;
- is adequately insured; and
- is required to undergo continuing professional development/education in the area of insolvency law

Query 2.2.1c

Is this an appropriate method of determining viability?

The stated role of the restructuring adviser would be to form an opinion as to whether the company is 'viable'. It is proposed that the test of viability be whether the company can avoid insolvent liquidation, and be returned to solvency within a reasonable period of time. The Department agrees with this method.

Query 2.2.1d

What factors should the restructuring adviser take into account in determining viability? Should these be set out in regulation, or left to the discretion of the adviser?

Certain factors should be set out in regulation and in the context of maintaining the integrity of the FEG scheme this would include the consideration and treatment of employee entitlements.

There is no obligation for a company to pay, or to provision to pay, employee entitlements until they accrue, for example, when an employee takes leave. Some employee entitlements are accruable by law regardless of circumstance, for example annual leave and long service leave. Other employee entitlements are accrued on a contingent basis in the event that certain circumstances arise, for example sick leave, payment in lieu or notice or redundancy pay.

Relevantly, in determining the viability of a company, a restructuring adviser should have appropriate regard for any employee entitlements that are likely to accrue during the safe harbour period. Further discussion of the treatment of employee entitlements is in the Department's response to query 2.2.3 below.

The requirements to be set out in regulations should be drafted in such a way that the adviser has discretion to take into account other factors, noting that each company's liquidity issues may be unique to that company and its particular circumstances.

Query 2.2.1e

The Government seeks views from the public on whether these are appropriate protections and obligations for the restructuring adviser, and what other protections and obligations the law should provide for.

Appropriately qualified professionals should be encouraged to offer their services as restructuring advisers with the safeguard of appropriate protections. Relevantly, in situations where a restructuring adviser successfully assists a company to overcome its liquidity issues and continue trading, there are a number of benefits that flow to the wider community. These include increased innovation and entrepreneurship, reduced levels of unemployment and economic growth (particularly in regional areas that are reliant on industry), and a reduction in the cost to taxpayers in the administration of FEG and other safety net schemes.

Nonetheless, should a business subsequently fail despite the restructuring adviser's determination of viability, the interests of the FEG scheme are better served if there is an adequate mechanism by which a restructuring adviser, who has been dishonest or negligent in providing advice, can be held accountable by a liquidator for losses arising out of this dishonesty or negligence.

The Department notes that a restructuring adviser would be unable to be appointed in any subsequent insolvency without the leave of the Court. Further guidance is needed on the circumstances in which a Court might exercise this discretion. In particular, the impartiality of the voluntary administrator and liquidator is critical. In this respect, it may be beneficial for the Court to be bound by legislative criteria that include consideration of the impartiality of the restructuring adviser.

Further consideration should also be given to the payment of restructuring advisers' fees, and in particular, whether an adviser will have priority to payment of their fees in the winding up of a company.

Query 2.2.2a

Do you agree with this approach?

The Department agrees with the proposal that upon any subsequent liquidation of the company, directors may be subject to a civil claim in relation to any outstanding employee entitlements which accrued during the safe harbour period.

Query 2.2.2b

Do you agree with our approach to disclosure?

The Department agrees that disclosure of the company's financial distress and appointment of a restructuring adviser may have detrimental consequences that jeopardise the successful restructuring or turnaround of the company companies.

Therefore the Department supports the proposal that directors do not need to disclose whether they are operating in safe harbour and that changes to a company's continuous disclosure obligations are not required.

Query 2.2.3

The Government seeks views from the public on in what other circumstances should the safe harbour defence not be available?

The Department strongly supports making the safe harbour defence unavailable to directors with a history of 'phoenix activity' that has resulted in employee creditors losing their accrued employee entitlements. This should be regardless of whether or not those entitlements were subsequently protected by payments under FEG or its predecessor the General Employee Entitlements and Redundancy Scheme (GEERS).

The Department welcomes the proposal that the Australian Securities and Investments Commission (ASIC) or the Court would be empowered to make a determination that a person be ineligible to rely on the safe harbour defence in the circumstances set out in the paper. Further detail on the the proposed regulatory oversight and standing requirements for this provision are needed to effectively manage these exclusions.

<u>'Significant failure' to pay employee claims</u>

The reform proposal includes that the safe harbour defence will not be available where there has been a 'significant failure' to pay employee claims, Pay as you go (PAYG) withholding and employee superannuation which accrue or are incurred both before and during the safe harbour period. The Department strongly supports this stance as it strikes at the heart of the tension that can arise between FEG and insolvency law reform.

A significant factor that has not been adequately addressed is how these provisions should operate taking into account contingent liability that only arises on termination of employment (for example redundancy pay). The safe harbour exception appears to be limited to accrued employee entitlements crystallised at the date that safe harbour is invoked. However in the event of company failure, the exposure of the FEG scheme encompasses all outstanding employee claims that will crystallise on <u>termination of employment</u> which may be far greater than the claims that have crystallised at the <u>date of safe harbour</u>.

Therefore the Department recommends that failure to make adequate provision for all employee entitlements that become payable on termination of employment trigger the exception to the defence. The restructuring adviser should be required to provide details of any employee entitlements owing or outstanding at the time safe harbour was entered, and the quantum if these claims were to crystallise should a successful turnaround not be achieved, in the 'Restructuring Plan' at 2.2 above.

Special consideration should be given to the treatment of uncrystallised employee claims which accrue during the safe harbour period. .

Safe Harbour Model B

Query 2.3

The Government seeks your feedback on the merits and drawbacks of this model of safe harbour.

As detailed in is response to 2.2 above, Model A is the preferred option for providing safe harbour for directors, whilst protecting the interests of the company's creditors. As a significant unsecured creditor, the Commonwealth is frequently disadvantaged in the quantity of its dividend because of significant additional debts incurred as a result of last ditch recapitalisation efforts.

The Department notes the following significant drawbacks in relation to Model B:

- It would be open to directors to seek the formal appointment of an adviser to provide advice on restructuring issues, but the adviser not be subject to the same stringent requirements as envisaged in Model A. The Department is concerned that this may result in unscrupulous behaviour and the exploitation of the safe harbour model.

- The burden of proof would rest with the liquidator to prove all three limbs of the carve out; whereas under Model A this onus is on the director to refute the claim of insolvent trading while provides a stronger deterrent against exploitation of the safe harbour arrangements.

- Further clarification about the meaning of 'reasonable steps' and 'reasonable time' is required, as well as what is meant by the term 'materially increasing the risk of serious loss', and whether these elements would be an objective or subjective standard. If the latter, there is a risk that directors would be given considerable latitude to trade-on where the solvency of the company would otherwise be in question.